July 14, 2004

The Honorable Robert Bunda, President
and Members of the Senate
Twenty-Second State Legislature
State Capitol, Room 003
Honolulu, Hawaii 96813

Dear Mr. President and Members of the Senate:

Re: Senate Bill No. 3193, S.D.2, H.D.2, C.D.1

On July 13, 2004, Senate Bill No. 3193, entitled "Relating to Consumers" became law without my signature, pursuant to Section 16 of Article III of the State Constitution.

The main purposes of this bill are: (1) repeal the maximum pre-tax gasoline retail price cap originally enacted by Act 77, Session Laws of Hawaii 2002; (2) revise the formula for calculating the maximum pre-tax wholesale price cap and extend its applicability to all grades of gasoline; (3) change the implementation date for the maximum pre-tax wholesale price cap from July 1, 2004 to September 1, 2005; and (4) establish a legislative task force to investigate the petroleum industry and its operations on the neighbor islands.

In section 1 of Senate Bill No. 3193, the Legislature stated that, since the passage of Act 77, it has found that there is competition at the retail level. The Legislature stated that it also found that the problem of high gasoline prices is principally due to a lack of vigorous competition in the wholesale market. The Legislature, therefore, determined that revisions to Act 77 were necessary and decided to further delay the implementation of gas caps until September 1, 2005. The fact the Legislature passed a measure that will not take effect for over a year and this replaced a bill enacted in 2002 with a two-year delayed start indicates that even supporters of gas caps were not sure of what they were doing.

The revised price caps contained in this bill could create adverse effects for Hawaii's gasoline consumers. First, the price caps may bring unwanted and unwarranted volatility to the Hawaii market. The bill's price caps are benchmarked to gasoline spot prices in three volatile spot markets, namely the New York, Gulf Coast, and Los Angeles spot markets. These markets also exhibit seasonal pricing changes that have no factual nexus to Hawaii. In effect, the bill links Hawaii to external and unrelated markets.

Second, the new benchmark prices will increase the risk of supply shortages beyond the shortage risks posed by Act 77 price caps. The use of price caps, coupled with the low

Location Adjustment Factor of $.04 per gallon for shipping, may provide Hawaii refiners with the motivation to ship all grades of gasoline to the higher value West Coast markets. This motivation could bring serious consequences to the entire state.

Third, wholesale caps alone will not achieve the bill's objective "to enhance the consumer welfare by fostering the opportunity for prices that reflect and correlate with competitive market conditions." Even if the wholesale price caps could somehow lower wholesale prices, there is no guarantee that they would "enhance consumer welfare," which is presumed to mean lower retail prices. Indeed, it is more likely that integrated wholesale/retail marketers would recoup losses from capped wholesale prices by raising uncapped retail prices in their retail outlets.

Moreover, a common problem with price controls is that the price charged has a strong tendency to be at the price cap, even if costs are falling. This phenomenon occurs in order to make up for losses when the caps limit margins. In addition, price caps can legitimize this type of price setting, because the price caps are viewed as an "implied permission" to price at what government allows.

Fourth, the bill fails to recognize that Hawaii's wholesale gasoline market has a diverse, complicated, and intricate structure. An inaccurately differentiated wholesale price cap could cause major structural market changes. This could mean potential loss of service to small jobbers and re-concentrate the wholesale market, reducing or eliminating improvements in wholesale competition. In addition, the complicated nature of Hawaii's wholesale gasoline market makes it less transparent for purposes of monitoring and enforcing price caps.

The bill's logic, which attributes high gasoline prices primarily to a lack of vigorous competition in Hawaii's wholesale market, fails to recognize changes in the market. For example, Aloha Petroleum's import terminal that opened in 1998 spurred wholesale competition in Hawaii. Aloha first imported gasoline and in 2001 used the terminal to leverage a supply agreement with Chevron at or below the import parity price. Increased competition is reflected in new market entrants, most notably Aloha and Costco.

Price controls cannot address the significant challenges Hawaii faces, such as increased crude oil prices buoyed by an unstable Middle East, strong international demand, stagnant local refining capacity, reduced import options, and a variety of national, regional and state environmental specifications that create requirements for specialty petroleum products.

Finally, price caps and the anti-business message they send are likely to discourage investments vital to the fostering and retention of a robust economy in this state. The main benefit of allowing SB 3193 to become law is the fact that this bill postpones the price caps until September 1, 2005.

Therefore, I allowed Senate Bill No. 3193, S.D.2, H.D.2, C.D.1 to become law as Act 242, effective July 13, 2004, without my signature. My Administration will introduce legislation in the next session to repeal this act.

Sincerely,

LINDA LINGLE